

EAP Task Force

Document 25

**Joint Meeting of the EU Water Initiative's EECCA
Working Group and the EAP Task Force Environmental Finance
and Water Networks**
29 March –1 April 2005, Chisinau, Moldova

**Summary Report of a Pre-feasibility Analysis of a Debt-for-
Environment Swap in the Kyrgyz Republic**
Preliminary Results

This document is prepared on the basis of the draft report of the Pre-feasibility Analysis of a Debt-for-Environment Swap in the Kyrgyz Republic. It provides preliminary findings and conclusions of the analysis conducted. This document will support the discussion on Facilitating Dialogue on Opportunities and Risks of Debt for Environment Swaps which will be held during Session 8 on the third day of the meeting. Participants are invited to discuss and comment on the conclusions emerging from the preliminary analysis of such swaps as a mechanism to raise additional resources for environmental expenditure in the EECCA countries.

ACTION REQUIRED: For information and discussion

Summary Report of a Pre-feasibility Analysis of a Debt-for-Environment Swap in the Kyrgyz Republic Preliminary Results

I. Background

Since its independence, the Kyrgyz Republic has accumulated a substantial amount of foreign debt which it has not been able to service. This is a paradox, as the Kyrgyz Republic began the transition period with no external debt whatsoever¹. In addition, in the middle of the 1990s, the Kyrgyz Republic was a leader of economic reforms among the former Soviet Union Republics. Currently, in USD terms, the Kyrgyz Republic is among the poorest countries in the world². At the same time, it is also a severely indebted country³. As a low-income severely-indebted country, the Kyrgyz Republic is eligible for debt relief as part of the initiative on debt relief for the poorest countries of the former Soviet Union (the so-called CIS-7 Initiative) which includes Armenia, Azerbaijan, Georgia, the Kyrgyz Republic, Moldova, Tajikistan and Uzbekistan.

In 1993, the Kyrgyz Republic was the first to embark on an IMF-support programme aimed at stabilizing and transforming its economy. The presence of IMF funding attracted other credit resources from institutional creditors. The discovery of gold fields on the Kyrgyz territory at about the same time as well as the implementation of the IMF support programmes brought economic growth at high rates. However, with a hypertrophied public sector, the prospects of economic growth without fiscal adjustments were simply unrealistic.

The devaluation crisis experienced in the middle of 1996 (by almost 50%) led to an abrupt increase in the public debt expressed in domestic currency. As a result, an agreement was signed with the Russian Federation on debt restructuring. In 2002, the Kyrgyz Republic agreed with Paris Club⁴ creditors on external debt restructuring. The agreement included an explicit clause allowing each creditor, on a voluntary and bilateral basis, to undertake debt swaps, such as debt-for-nature, debt-for-aid, debt-for-equity or other local currency debt swaps. Following the agreement with the Paris Club, the Kyrgyz authorities successfully completed negotiations with essentially all bilateral creditors on terms comparable to those of the Paris Club. While these agreements have significantly lowered Kyrgyz debt service obligations, the debt stock remained high and negatively affected the economic prospects of the country.

II. Debt-for-Nature/Environment Swap

¹ This is so because as soon as after 1991, the Russian Federation, as agreed with the creditors, offered the other EECCA to take over all official foreign liabilities of the former Soviet Union.

² According to the World Bank definition (World Bank Global Development Finance), a country is classified as low-income when the annual GNP per capita is equivalent to or less than US\$ 760 in 1998 prices. There are about 60 low-income countries in the world, including 8 EECCA: Armenia, Azerbaijan, Georgia, the Kyrgyz Republic, Moldova, Tajikistan, Ukraine and Uzbekistan.

³ The World Bank definition of a severely-indebted country means that either of the two key ratios is above critical levels: present value of debt service to GNP (80 percent) and present value of debt service to exports (220 percent). Currently 48 countries are classified as severely-indebted countries, including the Kyrgyz Republic and Tajikistan of EECCA.

⁴ The Paris Club is an ad-hoc body of bilateral creditors (mostly OECD, although it includes Russia as well) that negotiates rescheduling agreements with debtor countries on a case-by-case basis. It was formed in 1956 and it meets on a monthly basis in Paris.

The clause on the debt swaps, included in the 2002 agreement with the Paris Club, opened a window of opportunity for the Kyrgyz Republic. Following the Paris Club agreement, at the initiative of the Ministry of Ecology and Emergencies, the Kyrgyz Government established an inter-ministerial working group, to discuss and develop modalities for utilizing the opportunity presented by debt-for-environment swap (DFES). At present, there seems to be a greater willingness among the international community to consider debt-for-environment swaps than there has been in the past. There is also an opportunity for the Kyrgyz Republic to link the debt-for-environment swap initiative with the existing CIS-7 Initiative. The Kyrgyz Government is also trying to advance and link the DFES idea to a UN initiative on Poor Mountainous countries.

In addition, the Ministry of Ecology and Emergencies requested the EAP Task Force Secretariat (OECD) to assist in establishing a framework for bilateral negotiations of debt-for-environment swap with creditors, similar to the assistance that the EAP Task Force had earlier provided to Georgia. The project on “Pre-feasibility Analysis, Project Pipelines and Institutional Support for Debt-for-Environment Swap in the Kyrgyz Republic” was formalised and officially launched in November 2004. The project is financed by the EU Tacis. UNDP is also supporting the Kyrgyz Government in this process.

Box: What is a Debt-for-Environment Swap

A debt-for-environment swap is a transaction that cancels (part of) a country’s external debt for its commitment to spend an equivalent amount, or a portion of the reduced liabilities in the country, in local currency on agreed conditions, to finance “brown” or “green” environmental projects. These transactions can be bilateral (mainly between governments to swap official debt) or can be facilitated by a third party (environmental NGO or broker), when private debt is mainly involved.

The main objectives of the OECD-supported project are:

- To assist the Kyrgyz Government in analysing opportunities for and challenges to swapping external debt for domestic financing of environmental projects, including:
 - analysis of debt profile, debt sustainability and repayment schedule;
 - analysis of priority creditors for bilateral DFES;
 - analysis of the fiscal capacity to service DFES scheme;
 - compatibility with planned debt treatment operations;
 - analysis of pros and cons of different types of swaps – debt-for-aid, debt-for-equity, debt-for-nature;
 - institutional, legal and regulatory issues; and,
- To set priorities for negotiations with potential bilateral creditors through developing a credible and convincing expenditure programme by identifying 3 most promising project pipelines.

The focus of this study is on external public and publicly-guaranteed long-term debt owned to official bilateral creditors.

In mid-March 2005, the Kyrgyz Republic held another round of negotiations with Paris Club creditors. Paris Club creditors agreed on restructuring the stock of the public external debt of the Kyrgyz Republic. The 2005 agreement with the Paris Club allows the Kyrgyz Republic to restore the sustainability of its external public debt and to solve the solvency problems of the country. The agreement also includes a clause on debt swaps.

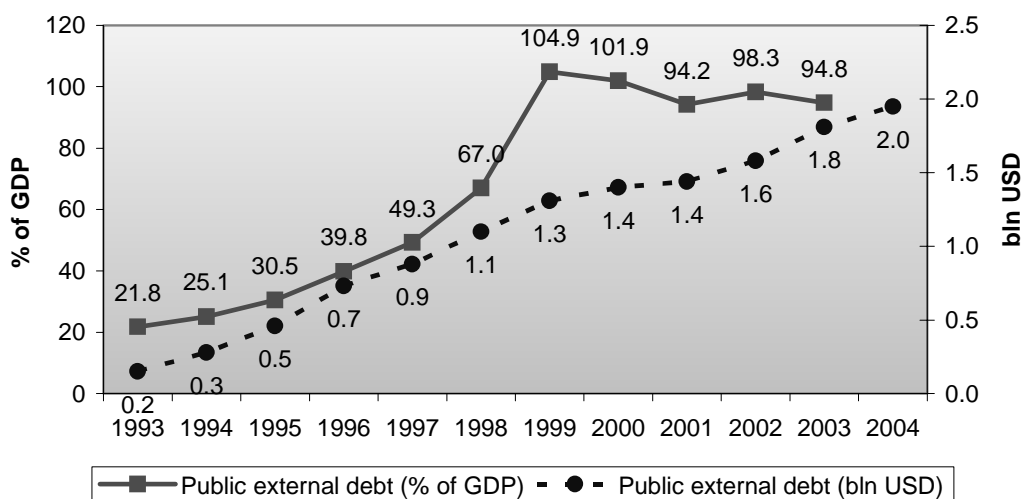
The results presented below however reflect the situation prior to the March 2005 agreement with the Paris Club. This analysis will be updated to include the most recent developments. While some of the numbers in the analysis will have to be adjusted, the overall conclusions will most likely stay the same.

III. Preliminary Analysis of the External Public Debt Profile of the Kyrgyz Republic

During the past several years the overall economic situation in the Kyrgyz Republic has significantly improved. The country has succeeded in achieving stable macroeconomic growth and low levels of inflation, the economy has become more diversified outside of the traditional agricultural and mining sectors. Despite the progress made in key economic areas since 2001, the Kyrgyz Republic still faces significant challenges in servicing its external debt.

Although the external debt situation improved after the Paris Club flow rescheduling of March 2002, it remained unsustainable. Major debt ratios, though improved since 2002, are at a critical level. The external debt-to-GDP ratio is still slightly under 100%. As of the end-2003, the Net Present Value (NPV) of the debt-to-government revenue was 380%. The NPV of the debt-to-exports was 205%. Both indicators are far above the international debt sustainability thresholds. While the 2002 Paris Club agreement helped reduce the liquidity problem, it did not provide a lasting relief. The last debt sustainability analysis, carried by the IMF in 2004, showed that the Kyrgyz Republic was not likely to achieve debt sustainability by 2010 (according to the country's Debt Reduction Strategy) without a debt stock operation by Paris Club creditors⁵.

Chart 1: Public External Debt – Stock and Share in GDP



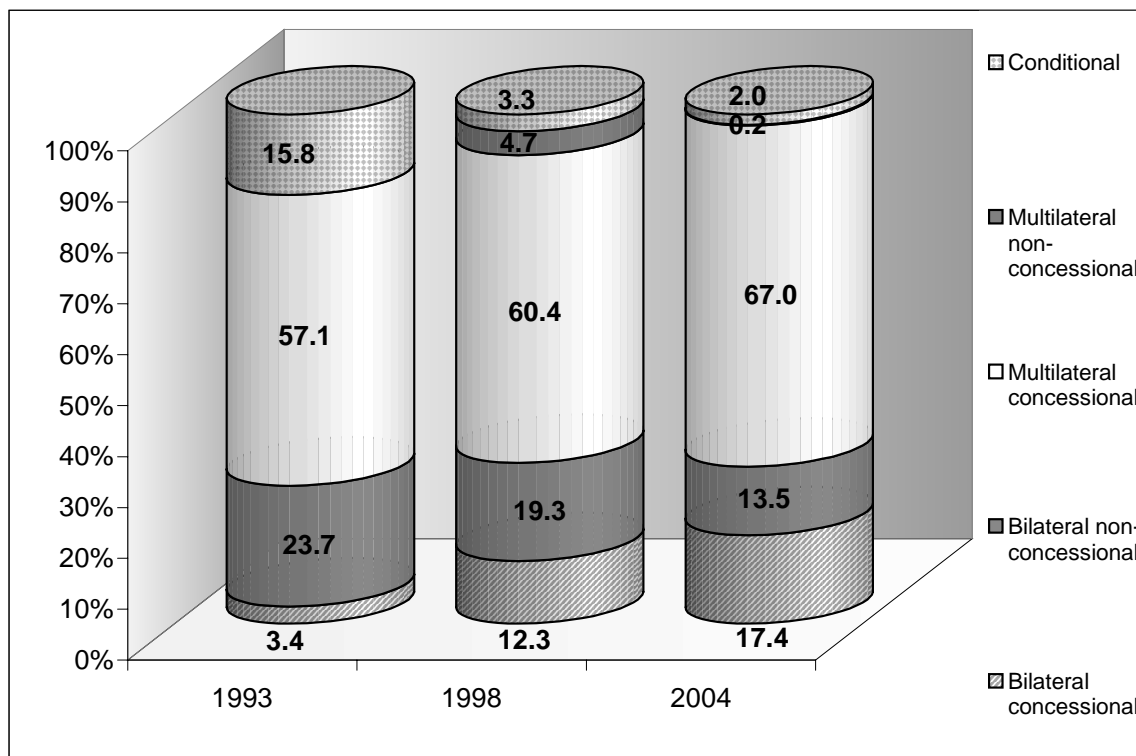
Source: Ministry of Finance

At the end of 2004, public and publicly-guaranteed debt of the Kyrgyz Republic amounted to USD 2.1 billion, with a 8.4% share of domestic debt (the Kumtor gold mine is excluded). The stock of external debt amounted to **USD 1.9 billion**. Most of the foreign debt is official – borrowed from foreign governments or

⁵ The stock debt restructuring was actually achieved in the March 2005 negotiations with Paris Club creditors.

from state institutions with sovereign guarantees. Of this external debt, **67.2%** was contracted with multilateral institutions, with the remaining **30.8%** of bilateral debt and **2%** of conditional liabilities.

Chart 2: Composition of Public External Debt by Creditor Type



Most of the Kyrgyz external debt is owed to multilateral creditors. Most of the multilateral loans are concessional (except for EBRD credit). Although multilateral loans are the biggest component of the external debt, they are not available for conversion, as multilateral debts cannot be rescheduled. The main argument is that multilateral creditors provide financing on concessional terms and offer new lending to debtor countries that would otherwise have no or only limited access to credit.

Bilateral debt is the most promising source of DFES. Most of the bilateral obligations are accrued towards Paris Club members (81.1%). In 2004, bilateral debt to Paris Club countries (including France, Japan, Germany, Denmark, and the Russian Federation) amounted to USD **487.1** million. The largest creditors are Japan and the Russian Federation, accounting for 71.6% of the bilateral debt. There is also Turkey, which is not a permanent Paris Club member but in the case of the Kyrgyz Republic was invited and participated in rescheduling sessions. The share of Turkey in bilateral debt is 7.7%. Bilateral debt to Paris Club countries and Turkey equals \$ 533.4 million.

Japan and Denmark are not candidates for DFES. These countries rejected such proposals in the past claiming that they do not have any legal basis to conduct debt swap programmes. The Russian Federation is a potential candidate, although its record of debt swaps is limited. It seems that Russia would be more

interested in debt-for-equity⁶ swaps. Of the group of countries participating in the 2002 debt rescheduling, the four most promising candidates for swaps are: France, Germany, Russia and Turkey.

Apart from for the above creditors, there are also bilateral credits extended by non-Paris Club members, namely Uzbekistan, China, Pakistan and India. Uzbekistan and China might have trans-boundary environmental interest in the Kyrgyz Republic as neighbouring countries. However, it is not clear to what extent countries such as India and Pakistan might be concerned with global environmental common goods. In the case of China, India and Pakistan credits were used for building factories. If any swap with these countries is considered, it would rather be a debt-for-equity conversion as a first choice. Therefore, these liabilities are not good candidates for DFES. As for Uzbekistan, it may be interested in some swap but probably only after successful arrangements with other creditors have been made.

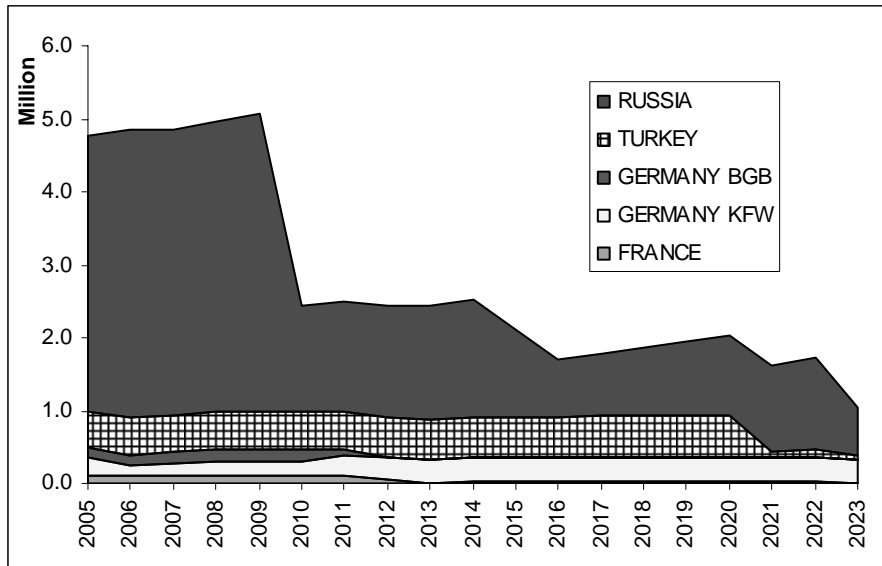
In conclusion, France, Germany, the Russian Federation and Turkey are the countries that make up the group of potentially good candidates for DFES. They owed USD 279.3 million of Kyrgyz debt at the end of 2004. Debt towards Russia accounts for 65% of this amount.

France and Germany are particularly promising with regard to DFES arrangements due to the presence of special programmes in these countries for debt reduction under the DFES arrangements and track record with such operations. There is already one swap experience between Germany and the Kyrgyz Republic. In 2004, Germany decided to write off Euro 750 000 of ODA⁷ debts conditional on the requirement that Euro 350 000 is spent on fighting tuberculosis.

⁶ A debt-for-equity swap is a transaction that cancels (part of) debtor country's external debt in exchange for local currency invested in equity (shares) in a domestic firm but also in natural resources stocks.

⁷ Official Development Assistance (ODA) is defined by OECD as aid flows to developing countries. To qualify as ODA, a transaction must be undertaken by the official sector for the main purpose of promoting economic development and welfare, be concessional in character and convey a grant element of at least 25%.

Chart 3: Schedule of Potential Revenue of 20% Debt Swap for the Kyrgyz Republic for 2005-2023 (in million USD)



Taking into account the existing experience of countries that have made DFES arrangements (e.g. Bulgaria, Poland), it is assumed that about 20% of the debt can be reduced through a DFES. Achieving a 20% conversion would be a great success for the Kyrgyz Republic. Chart 3 above presents the potential revenues that could be obtained from DFES, assuming a 20% swap rate on all repayments until the year 2023. The analysis assumes equal conversions in each year, which simplifies the calculation but probably is not a very realistic scenario. It should rather be expected that allocations will be made in increasing shares which only on average would equal 20%.

Probably not all potential creditors would agree to swap their credits. Those who agree would do it at different times and in different amounts, therefore the real flows would differ from the calculations presented above. The **main preliminary conclusions** that are emerging from the above analysis show that:

- The largest creditor in the group of potential candidates for DFES is Russia but it is also probably the least interested. Russia might be more interested in debt-for-equity swap. Therefore, the potential Russian participation remains a question mark. Without the Russian presence, the potential flows decrease to \$ 16 million. The next largest creditor in this group is Turkey, which is also not particularly interested in debt conversion operations. Without Turkish participation, there are only France and Germany which realistically could be expected to get interested in swapping debt (although a track record is likely to attract other creditors, in the medium term).
- The estimated annual amounts are not impressive. With the participation of all 4 countries over \$ 4 million could be made available annually. However, with the participation of France and Germany only, the available amount is USD 400 thousand annually.
- With the March 2005 debt stock rescheduling operation with the Paris Club, the calculations presented above will change. They will be adjusted in accordance with the terms of the new Paris Club agreement. These adjustments would change the numbers but probably not the conclusions.

- There is a chance though that the potentially available revenue would be augmented by donors through technical assistance or additional grants. However, such a situation is more likely after the financial mechanism established to manage the DFES resources gains sufficient reputation and credibility.

In conclusion, a DFES scheme is feasible and relevant for the Kyrgyz Republic. However, the situation is not comparable with that of Poland or Bulgaria, and not even with Georgia. Yet, there is some debt which could realistically be considered for a swap. Although, the potential resources are limited, given the low level of domestic public environmental expenditure in the Kyrgyz Republic (0.4% of GDP in 2002), any additional resources, if appropriately targeted, could bring benefits to the country. Given the above revenue forecast, it seems that the necessary financing which would be required by the Kyrgyz Republic would be in the range of its financial abilities. With this level of resources, the potential inflation risk is limited.

IV. Analysis of Potential Pipelines to be Financed from the DFES

The experience of countries successfully implementing DFES schemes shows that irrespective of the institutional set-up for managing DFES resources, creditors should be convinced that the country will have institutional capacity to manage foreign expenditure in a transparent, effective and efficient manner in accordance with good international standards. For this purpose, a well-developed and justified expenditure programme based on transparent and robust project selection criteria and implementation rules and procedures should be developed.

Indeed, establishing a credible expenditure programme that responds to priority concerns of both creditors and the Kyrgyz government will be essential to gain support for a debt-for-environment swap. The proposed programme should be narrowly focused on a few priorities and demonstrate how a solid pipeline of projects could be prepared and supported to meet its objectives. A review of the Kyrgyz environmental priorities and creditors' preferences suggests that the most promising priority areas could be those which aim at:

- Reducing pollution of regional waters;
- Protecting biological diversity; and,
- Reducing emissions of greenhouse gases which affect global climate.

Within each priority area, preliminary identification of project opportunities has been conducted with a view to identifying the types of projects that could achieve environmental benefits together with poverty reduction, local economic development and sustainable growth and international security goals. In addition, particular attention has been paid to projects which aim at solving problems common to the entire Central Asian region, such as soil degradation, erosion and desertification.

Given the potential DFES resources, the following preliminary project pipelines under each of the above priority areas, have been identified:

- Reducing pollution of regional waters – 1 project pipeline:
 - Improvement of wastewater collection and treatment in the coastal settlements of the Issyk-Kul Lake;
- Protecting biological diversity - 2 project pipelines:
 - Protection against land degradation;
 - Prevention of irreversible biodiversity loss; and,
- Reducing emissions of greenhouse gases which affect global climate - 2 project pipelines:

- Biogas production from animal waste;
- Rehabilitation of existing / construction of new mini-hydropower plants.

These project pipelines will be further discussed with the Kyrgyz Government to identify the 3 most promising ones which could be offered to potential creditors for their consideration.

Taking into account the possible size of the swap, additional sources of financing would be required to support any larger project pipelines. Therefore, careful selection of the most cost-effective projects, and requirements to co-finance projects from other sources, would need to be the cornerstones of project selection in order to make a real difference in any of the priority areas listed above.

Notwithstanding the quality of the project pipelines, the Kyrgyz authorities still have to reflect on the most appropriate institutional set-up to manage, monitor and report on this expenditure programme. Alternative tools and procedures have to be assessed and discussed with creditors, that will take into account the nature of the programme and the institutional capacity in the country.

V. Overall Conclusions

Following the 2005 agreement with the Paris Club, the Kyrgyz Government will have to finalise negotiations with individual creditors by the autumn of 2005. If preparatory activities go as scheduled, realistically the first swap agreements could be signed in 2006. The debt-for-environment swap could be included in the 2007 budget law. It would take at least another 6 months or so to develop the first project pipeline and prepare it for the first appraisal session. This would imply that the first financing agreements and disbursements to projects could be expected at the beginning of 2008.

The main conclusion of this study is that a debt for environment swap between the Kyrgyz Republic and creditors of the Paris Club is feasible and could generate benefits for the Kyrgyz Republic and the international community, including creditors. Lessons learned from the Kyrgyz case could be relevant for other low-income countries in the region and beyond. They include:

- The project relies on a thorough analysis of the debt portfolio;
- It requires a strong cooperation between the Ministry of Finance, who leads the discussions with creditors, and the Ministry of Environment, who is instrumental in identifying an attractive expenditure programme (project pipelines). Both institutions are also involved in the design, and the management of the structure that will monitor the implementation of the expenditure programme;
- The expenditure programme is a key feature to attract creditors' attention. Apparently, it should focus on poverty reduction measures and issues that are relevant at a global and regional level;
- The process takes time to materialise (about 4 years in the case of the Kyrgyz Republic); hence the necessity to have a stable policy and institutional framework, with a strong commitment that lasts over time.

Harnessing this opportunity will not be easy. However, it is the most efficient way to secure public finance to environmentally-related projects, in countries where such commitments are fragile and always challenged by strong budgetary pressure.